directly or indirectly hinder the emergence of effective competition. The price strategies are only the most obvious: If the prices charged for essential inputs are above efficient levels, then entry will be deterred. The BOC has an incentive to misrepresent cost data and to misallocate costs in order to induce regulators to set prices for UNEs, interconnection and wholesale services which are too high. The BOC has an incentive to seek to restrict the range of services and UNEs which entrants may purchase and to argue for inefficient surcharges (*e.g.*, to subsidize its carrier-of-last-resort obligations or to recover historical costs) in order to force prices above efficient levels.

70. In addition to the pricing strategies suggested above, the BOCs can avail themselves of a wide range of nonprice strategies which are often more difficult to detect and deter. Entry into local exchange services is difficult because it requires a huge investment and depends on cooperation from a hostile competitor. While the Act provides the public policy framework for addressing these issues (in the Section 251 requirements), implementation of these rules will be difficult.

71. Economists have identified several price and nonprice strategies which may be employed by a monopolist such as a BOC to exploit, extend, and protect its market power. First, a monopolist can exploit its market power by setting high prices, generally well above costs. Moreover, a monopolist chooses the range of products to offer based on what maximizes profits for the monopolist, not what consumers most want. In some cases, this results in poor quality (because consumers have no choice but to accept what the monopolist

offers) or in other cases, excessive investments in features which appeal to only a subset of customers but for which the monopolist can force all customers to pay (*e.g.*, investments in broadband services). Traditionally, regulators have attempted to control these activities by setting quality standards, by determining what capital investments are allowed into rate base, and by setting prices for retail services -- and by restricting the monopolist's participation in competitive markets (*e.g.*, long distance services) to protect those markets and to limit the monopolist's ability to circumvent regulatory controls. However, such control is imperfect because the monopolist BOC possesses superior information regarding the actual nature of its costs and consumer demand.

72. Second, a monopolist may seek to extend its market power by "monopoly leveraging." That is, a monopolist in one market may seek to extend its power to another related market, which is most easily accomplished when the monopolist controls an essential input in the second market. By tying or bundling the purchase of the goods in the two markets, the monopolist can extend its power over both markets. For this reason, the courts have often acted as if there is a *per se* restriction against tying where the firm has market power, in spite of the fact that more recent economic theory suggests that there can be efficiency-based motivations for tying and that the circumstances under which this is the preferred mechanism for extending monopoly power are limited. However, tying is likely to be attractive as a mechanism for avoiding rate regulation (*e.g.*, if the essential input is subject to a price ceiling that limits the BOC's ability to extract profits from its sale).

73. Third, and perhaps most likely, a monopolist is likely to seek to protect its market position by "raising its rivals' costs," a generic expression for a whole class of price and non-price predation and foreclosure strategies.[75] The BOC can potentially raise an entrant's costs by manipulating any of the price or non-price terms associated with the essential inputs which the entrant requires to effectively compete in the market (*e.g.*, interconnection services, UNEs or wholesale versions of retail services). In addition, BellSouth can provide inferior-quality service unless regulators are vigilant and contracts regarding interconnection, UNEs, and wholesale services are suitably specific in their requirements.[76]

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[75] An upstream monopolist (*i.e.*, the BOC which controls local exchange access) generally will have an incentive to discriminate against downstream rivals (*i.e.*, interLATA competitors) as explained in recent papers by Nicholas Economides (see Nicholas Economides, "The Incentive for Non-Price Discrimination by an Input Monopolist," Mimeograph, Stern School of Business, New York University, January 1997) and by Randolph Beard, David Kaserman and John Mayo (see Randolph Beard, David Kaserman and John Mayo, "Regulation, Vertical Integration and Sabotage," Mimeograph, University of Tennessee, January 1997). The findings of these stand in contrast to the result proposed in a recent working paper by David Sibley and Dennis Weisman (see David Sibley and Dennis Weisman, "Competitive Incentives of Vertically Integrated Local Exchange Carriers: An Economic and Policy Analysis," *Journal of Policy Analysis and Management*, vol. 17 (1997). Sibley and Weisman err by assuming that the downstream (interLATA) subsidiary of the BOC maximizes its own profits and fails to take account of the consequences of its decisions for the profits of the integrated company. Such an assumption is inconsistent with rational value maximization.

[76] For example, Ameritech attempted to frustrate the Michigan Public Service Commission's June 26, 1996 order to implement intraLATA toll dialing parity within thirty days. The BOC was required to grant a 55 percent discount on access charges in central offices where it failed to provide such parity. Ameritech actually chose to reduce access charges by 55 percent rather than to expand dialing parity beyond the 10 percent of access lines for which it had already implemented dialing parity. (See Ameritech News Release, "Ameritech to Cut Access Rates to Long Distance Companies," July 26, 1996; and *Ameritech Michigan v. Michigan Public Services*

74. Alternatively, a BOC may seek to create "customer switching costs" in order to make it more difficult for an entrant to attract new customers -- for example, anything which damages the reputation of the new entrant (*e.g.*, poor-quality service due to slow delivery, maintenance or repair, or noisy local loop facilities), makes it difficult for a customer to learn about new entrants (*e.g.*, misleading advertising by the BOC), or makes it difficult for a customer who wishes to change suppliers to actually do so (*e.g.*, cumbersome procedures for effecting the transfer of customers to a new local service provider).

4. Indirect strategies for frustrating competition

75. The preceding discussion highlight some of the more obvious direct strategies which may be employed to hinder progress towards effective competition.[77] There are also many indirect strategies which can be as effective in slowing the emergence of local exchange competition. These indirect strategies are even harder to detect and hence even more difficult to deter.

76. The emergence of local competition is likely to encourage the development of new and innovative products and services which will further complicate what is already a

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Commission, MCI Telecommunications Corporation, and AT&T Telecommunications of Michigan, Inc., Court of Appeals Case No. 198706, Appellant Ameritech Michigan's Brief on the Merits at 12 ("Ameritech Complied With the Commission's June 26, 1996 Order By Implementing the 55% Access Charge Discount")(January 2, 1997).

[77] See also the more extensive discussion in B. Douglas Bernheim and Robert D. Willig, note 20, *supra*, Chapter 4.

very complex marketplace. The BOC will likely engage in a wider array of markets of varying degrees of competitiveness and subject to varying degrees of regulatory oversight. Therefore, preventing cross-subsidization and other attempts to circumvent regulations by actions taken in unregulated markets will become more difficult.

77. Moreover, the possibility, on occasion, of an "efficiency" rationale for strategies that have anticompetitive consequences provides the BOC with ample opportunities to deny plausibly that a particular strategy is being employed for anticompetitive purposes. In the face of rapid technological progress, it may be impossible to reverse the damage caused by the strategy if regulators wait until the damage becomes evident. Even if the BOC were enjoined from using the anticompetitive strategy in the future, new versions of such strategies can be used, and the BOC has the first-mover advantage of being able to decide when and how to move.

78. Four classes of examples illustrate some of the strategies. First, because an entrant requires the BOC's cooperation in order to arrange interconnection, purchase UNEs, and resell wholesale services, the BOC can devote insufficient resources to the task of sustaining this cooperation. The promotion of competition will require active cooperation by the BOC; its neglect or slow response time, therefore, can be quite effective at thwarting competition. As Professor Marius Schwartz has stressed, such anticompetitive conduct can be difficult to police, because "the great asymmetry of information between a BOC and outsiders about what constitutes unreasonable delay in implementing new systems is likely to

make enforcers leery of imposing heavy penalties for perceived foot-dragging."[78]

79. Second, the BOC may exploit its ability to discriminate selectively. Because the BOC controls the timing, design, and scope of its facility upgrades and the services it offers, it can manipulate these activities strategically to affect rivals differentially. It will be quite difficult to prove that a BOC delayed implementation of a feature required by an entrant because it wished to harm the entrant as opposed to its technical or other inability to respond sooner. Alternatively, a BOC can choose the level of quality which it offers to all entrants in such a way as to harm particular entrants selectively. For example, the BOC may argue that it is implementing a minimal functionality, "lowest common denominator" systems interface in order to avoid discriminating against limited-capability entrants when the real motivation is to deny access to increased functionality to more threatening competitors.

80. Third, seemingly "nondiscriminatory" quality degradation can be discriminatory in the following important sense: Entrants to local exchange services must establish a reputation for quality in order to attract customers, and a reduction in overall quality that coincides with the onset of competition would increase the difficulty of acquiring such a reputation. Similarly, local service quality problems which can be assigned to the onset of competition will mislead consumers regarding the benefits of competition and may make it more difficult for state commissions to implement the requirements of the Act. Finally, a reduction in quality could damage the investments of long distance carriers in their

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[78] *Supplemental Affidavit of Marius Schwartz*, ¶ 38, *supra,* note 74.

reputations for quality service, narrowing any consumer perceptions that long distance carriers offer better service than the BOC.

81. Fourth, while the Act requires the BOC to cooperate, the Act is quite complicated and its provisions and requirements are unlikely to be fully understood by the ILEC's employees. An ILEC does not need to tell its employees to be uncooperative or to try to mislead customers about the likely impact of competition. Indeed, many of the employees may decide to behave in this way on their own. The BOC's employees are likely to associate the onset of competition with increased job insecurity and the language of healthy business competition often characterizes competitors as "the enemy." Therefore, by failing to devote adequate resources to supervising or educating employees of their obligations under the Act, FCC regulations and arbitrated decisions, a BOC may be able to implement a decentralized, anticompetitive strategy or have it implemented on its behalf by its employees. This is especially difficult to protect against because it does not require centralized coordination; there does not need to be a smoking gun.

82. Whether the ILEC uses neglect, fails to supervise workers adequately, strategically chooses "nondiscriminatory" service standards so as to harm competitors, allows overall quality to degrade, mobilizes opposition to competition, or other anticompetitive strategies, the effect will be the same: *Progress toward effective competition will be slowed.*

5. Ample evidence that BellSouth has behaved so as to hamper progress of local competition

83. The best evidence of this incentive and ability to hamper competition for local

exchange service is BellSouth's failure to comply with the Act.[79] BellSouth is currently thwarting local market entry through total service resale by restricting the resale of contract service arrangements ("CSAs"). Indeed, the FCC expressly rejected BellSouth's previous arguments that contract offerings should be exempt from the wholesale discount requirements and the Eighth Circuit upheld the FCC's findings.[80] Nonetheless, BellSouth's SGAT provides that the statutory discounts "do not apply" to contract service arrangements.[81] BellSouth's restrictions effectively insulate large portions of the market from resale competition, because BellSouth has entered into CSAs with many larger businesses (and indeed has increased its use of CSAs recently).[82] These restrictions are anticompetitive.

84. BellSouth's anticompetitive conduct in response to the prospect of fledgling local competition is not surprising, in light of BellSouth's similar efforts to forestall the development of intraLATA competition after it was ordered by the South Carolina Public

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[79] See generally the affidavits of Jay Bradbury, Patricia McFarland and Jim Carroll, filed herewith.

[80] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order, ¶ 948 (1996); *Iowa Utilities Bd.*, 120 F.3d at 819.

[81] SGAT § XIV.B ("BellSouth's contract service arrangements entered into after January 28, 1997 are available for resale only at the same rates, terms, and conditions offered to BellSouth end users.").

[82] See the Affidavit of Patricia McFarland (Resale Aff.) filed along with our affidavit.

Service Commission.[83] In 1993, as part of an offering called "Calling Area Plus," BellSouth entered into an industry stipulation under which all carriers, interexchange carriers and LECs, would pay the same terminating access charges to the LEC that completed intraLATA toll calls.[84] However, as AT&T later discovered, BellSouth had entered into a side agreement with certain independent LECs, under which the LECs charged each other lower access charges than they were charging competing interexchange carriers.[85] When the deal was exposed, BellSouth was forced to enter into a new stipulation giving IXCs more favorable treatment.[86]

85. BellSouth has also thwarted competition by shrinking the intraLATA toll market. It has aggressively expanded its local calling areas, and thus transformed what used to be intraLATA toll calls (subject to competition) into local calls (which are not subject to competition).[87] Moreover, BellSouth has recently introduced new calling plans in Georgia

[83] South Carolina Pub. Serv. Comm'n Order No. 93-462. Before the South Carolina PSC ordered intraLATA competition, BellSouth opposed efforts to open that market to competition, see, *e.g.*, Georgia IntraLATA Competition Task Force Report, Docket 531194 (March 1, 1995), and even opposed services such as SDN and MegaCom that could incidentally be used to complete such calls, see Louisiana Pub. Serv. Comm'n Docket Nos. 17578, 17644, 17767.

[84] *Ibid.*

[85] See Attachment 3 hereto.

[86] South Carolina Pub. Serv. Comm'n Order No. 94-342, Docket No. 93-176-C (April 14, 1994).

[87] See, *e.g., Investigation into Defined Radius Calling Plans*, Docket No. P-100, Sub 126 (North Carolina Utils. Comm, May 17, 1994); "Expanded Toll-free Calling Area Approved," *Atlanta J. Const.*, Mar. 16, 1994.

and Florida that offer a flat-rate for all calls within the LATA.[88] In many instances, this flat rate is below the usage-sensitive access charges that its competitors must pay for the same calls. Through this classic price squeeze, interexchange carriers are prevented from competing with BellSouth, even if they are more efficient.

86. In addition, the Florida and Kentucky commissions have recently ordered BellSouth to stop employing a number of anticompetitive marketing practices in the intraLATA toll market (and a similar complaint is pending in Georgia). [89]

87. While these examples illustrate the range of strategies that BellSouth has employed to deter the emergence of effective competition, it is important to remember that because it is difficult to detect such behavior, only a small subset of anticompetitive activities are likely to be observed in the trade press and regulatory proceedings.[90]

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[88] BellSouth General Customer Service Tariff, A3.4.4.A.1; A3.4.4.B.1.a.(1)(a)(Florida); BellSouth Georgia General Subscriber Service Tariff, A3.42.

[89] Florida Public Service Commission Order No. P.S.C. 96-1659-POP-TP, Docket Nos. 960658-TP, 930330-TP; Kentucky Public Service Comm'n Case Nos. 95-285, 95-396 (Aug. 13, 1996); Complaint of MCI, AT&T, and Worldcom, Georgia Pub. Serv. Comm'n Docket No. 5319-U (Dec. 23, 1996).

[90] Professor Marius Schwartz discusses the generic shortcomings of regulation to control anticompetitive abuses, noting the greater difficulty associated with regulating new types of services (*e.g.*, markets for UNEs). Regulators must be able to (1) detect abuses, (2) prove that abuses have occurred; (3) deter abuses; and, (4) correct abuses. Each of these tasks is complex and likely to be further complicated by BOC entry into interLATA services. See *Affidavit of Marius Schwartz, Competitive Implications of Bell Operating Company Entry into Long-Distance Telecommunications Services*, note 12, *supra*, pages 45-47.

IV. CONSEQUENCES OF BOC ENTRY INTO LONG DISTANCE SERVICES

88. As we noted at the outset, we do not recommend the approval of BOC applications such as BellSouth's to compete in interLATA services pursuant to Section 271 of the Act at this time. We recommend delaying BellSouth's entry until the emergence of effective local exchange competition is safely assured. As long as BellSouth possesses significant market power over essential local exchange facilities, its entry into interLATA services will harm the competitive process in both local and long distance services. We believe that the likely consequence of premature BellSouth entry will be higher long-run prices, reduced consumer choices, and poorer-quality services for both long distance and local exchange customers. On the one hand, examination of the potential *benefits* of BellSouth's entry reveals consumers would gain little, if anything. On the other hand, examination of the potential costs of BellSouth's entry reveals that consumers are likely to face significantly higher costs of service.

A. Benefits of BOC Entry?

89. There are three types of benefits which proponents have argued will be realized when BOCs generally are permitted to enter long distance services:

i. Long distance markets will become more competitive.

ii. BOCs will be able to capture additional scale and scope economies through vertical integration.

iii. The promise of the opportunity to enter long distance services is the "carrot" which will induce the BOCs to cooperate with entrants.

90. Each of these alleged benefits is illusory. First, long distance markets are already effectively competitive; additional entry, therefore, will not make them meaningfully more competitive. Second, BOC vertical integration is unnecessary to capture such scale and scope economies as may exist when customers can purchase both local and long distance services from a single provider. Third, the "carrot" of long distance entry is effective only as long as the BOC has not been allowed to eat it. It will be necessary to induce the BOC to continue to cooperate with local exchange competitors as long as the BOC possesses significant market power over local services. The question is, again, not *if* a BOC should be allowed to compete in long distance, but *when* the BOC should be permitted.

1. Long distance markets will not become more competitive with BellSouth entry.

91. In Section III, we discussed the considerable evidence that demonstrates the vigorous nature of competition in long distance services. There is already significant excess capacity among just the three largest national facilities-based carriers. Moreover, the existence of a competitive wholesale market for bulk long distance transport means that entry and exit barriers for resellers are quite low. This makes the long distance market

competitive (*i.e.*, free entry precludes the earning of more than normal returns by incumbents). Therefore the addition of one or even seven new competitors will not meaningfully increase the level of competition. Furthermore, the BOCs would bring no new skills or resources to the market which are not already available in abundance and competing aggressively.

92. It is conceivable that long distance prices may fall in the short term if the BOCs are permitted to enter long distance services while they continue to maintain access rates vastly in excess of cost or attempt to buy market share by pricing interLATA services below cost. Such a strategy could emerge through cross-subsidization from a BOC's local service business; by integrating into long distance the BOC may strengthen its present dominant position in local services and perhaps establish future dominance over long distance services. Under such a strategy, a BOC might be willing to incur a short-term loss in providing long distance service if such a loss enables it to maintain monopoly control over local services. This opportunity would not exist if the BOCs were not allowed to compete in interLATA services until local service is effectively competitive because this incentive to pursue such a strategy disappears once the BOCs no longer have market power over local services.

93. Market conditions in long distance services indicate that current prices net of access prices cannot be significantly above long run incremental costs. Therefore a temporary price war which reduces prices below incremental costs in the short run would be

anticompetitive and would be likely to harm consumers' interests in the long run (*e.g.*, because of the adverse effect on incentives to invest or the adverse effect on the competitive process).

2. Entry by BellSouth is not required to capture scale and scope economies.

94. It is also incorrect to argue that vertical integration is required to capture scale and scope economies. First, the sources of these alleged scale and scope economies are not clear. Much of the technical progress which has made it feasible for competition to succeed in long distance markets -- and which promises the opportunity that competition may emerge in local exchange services -- has *reduced* the impact of network-level scale and scope economies. Digitalization, standardization, and modularization have made it feasible to support complex information services across networks which span multiple management and ownership domains. The Internet is a testament to this fact. Before these technical advances, it was much more difficult to manage distributed networks and claims of significant scale and scope economies were harder to dismiss. Today, there may still exist scale and scope economies within either the long distance or the local exchange networks, but it is not clear what network economies require integration of these two networks under control of a single end-to-end firm. Today, most analysts do not believe that end-to-end telephone services are a natural monopoly. Essential local facilities do, however, remain a *de facto* monopoly.

95. Second, if network scale and scope economies between local and long distance services do exist, then a BOC would have an unfair advantage because of its monopoly control over local network facilities. To guarantee effective competition in long distance services, regulators should continue to require equal access facilities and would need to make sure that the BOC did not exploit its unfair advantage to harm either local or long distance competition until effective local competition emerges.

96. Third, suppose that scale and scope economies exist, but that they are associated with *marketing* functions rather than with the network. There is ample evidence that many consumers will prefer one-stop shopping with the opportunity to purchase both long distance and local services from a single service provider. By bundling a package of services, a firm can economize on billing and marketing costs and can address customer-specific concerns more flexibly, thereby improving the quality of service. The promise of such opportunities for customer choice is anticipated to be one of the most important benefits delivered by increased competition in local services. However, it is essential that the customer be able to choose among more than one end-to-end supplier, and this would not occur with premature interLATA entry. Furthermore, resellers are able to capture the benefits of any marketing-level scale and scope economies.[91]

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[91] BellSouth affiant Richard Gilbert argues that economies of scale and scope "are likely to be significant, and may not be fully realizable through contracts." He does not, however, address the concerns we raise in this paragraph. See *Affidavit of Richard J. Gilbert on Behalf of BellSouth*, note 7, *supra*, page 16.

3. The promise of the opportunity to enter long distance services ceases to provide incentive for BOC cooperation once entry is permitted.

97. It is clear from Bellsouth's conduct described above, that a BOC has little incentive to cooperate willingly with regulatory policies which are intended to reduce its control over local exchange services. Therefore one might be tempted to argue that the BOC must be relieved of the restriction from entering interLATA services in order to provide the BOC with an incentive to cooperate in the emergence of local competition. There are a number of problems with this argument.

98. First, as we noted earlier, the carrot of interLATA entry ceases to be effective once consumed. Threatening a BOC with the possibility that it could be forced to exit if it behaves in an anticompetitive manner might not be sufficiently effective because regulators or a court may be reluctant to force a BOC to abandon sunk entry investments and it would be very hard to monitor its anticompetitive behavior as the earlier (and subsequent) discussion of its strategic options makes clear.

99. Second, this argument often implicitly assumes that the Act reflected a "bargain" with the BOCs in which they agreed to give up control of local services in return for something they wanted, namely entry into interLATA services. The Act could not have been a bargain with the BOCs because they had nothing to bring to the bargaining table. BOCs do not have a property right over local markets to use as a bargaining chip. The Act reflected a shift in regulatory paradigm to a new, market-based mechanism for protecting

consumer -- not BOC -- interests.

100. Finally, we do not believe it would be correct to deny the BOCs the opportunity to compete in interLATA services forever. However, delaying BOC entry until there is effective competition in local markets is neither inefficient nor unfair, but necessary for the realization of the Act's goal of full competition for all telecommunication services.

B. Costs of BOC Entry?

101. In general, premature BOC entry into interLATA services will incur five types of costs:

i. increasing the likelihood of anticompetitive vertical price squeeze strategies.

ii. increasing the likelihood of anticompetitive strategies designed to raise rivals' costs, more generally.

iii. increasing the likelihood of anticompetitive behavior based on cross-subsidization of interLATA markets.

iv. decreasing the likelihood that the BOC will cooperate with local exchange entrants, as required by the Act.

v. increasing the costs of regulatory oversight to protect consumers and the competitive process, and forestalling the development of local competition.

In each case, the competitive process in both long distance and local exchange markets will be harmed if the BOC is permitted to enter interLATA services while it retains its local monopoly.

1. Increased likelihood of anticompetitive vertical price squeeze strategies

102. A virtual monopolist who also sells a complementary service (by itself or through its affiliate) can impose a *vertical price squeeze* on a competitor in the complementary product market. This happens because the monopolist controls the price of an input of its competitor in the market for the complementary service.[92] For example, a BOC controls the price of access to the loop by an IXC. If the BOC, or its affiliate, is allowed to provide interexchange services as well, it can continue to price access to its competitors significantly above cost while pricing to itself at cost, and thereby squeeze the profit margin of the IXC. The vertical price squeeze can be pushed all the way up to the point where the IXC's profit margin becomes negative.

[92] BellSouth affiant D. John Roberts focuses his attention on the potential for predatory pricing by BellSouth; we agree that classic predatory pricing in this setting is unlikely given the financial health of the interexchange carriers. Professor Roberts acknowledges, however, that a vertical price squeeze, while not fitting within his analysis of "predation," "is clearly damaging to competition." See *Affidavit of D. John Roberts on Behalf of BellSouth*, note 8, *supra*, page 11.

103. Implementation of a vertical price squeeze by a BOC will allow the BOC or its affiliate to charge prices for interexchange services that are significantly (and artificially) below the prices of its rivals even though the BOC may be a less efficient provider. This is a potent and quick way for a BOC (or its affiliate) to gain market share and customer loyalty for interexchange services.[93]

104. Presently, the access market is monopolized. In the absence of regulatory intervention, the control of the access market by the BOC results in significant monopoly profits. The existence of high profit margins allows for the possibility of the implementation of the vertical price squeeze. As the Telecommunications Act of 1996 is implemented by the state commissions and as new facilities-based competitors enter the local exchange market, the market for access services, unbundled network elements, and local exchange services should become more competitive. Such competition will render a vertical price squeeze less effective. Thus, from the point of view of the BOC, the present is the opportune moment to impose a vertical price squeeze and gain significant market share in the IXC market.

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[93] Professor Schmalensee argues that an ILEC's ability to expand long-distance output even where it is less efficient than its rivals is not problematic because the loss in economic efficiency "would be outweighed by efficiency gains from the expansion of industry output as long distance prices are driven closer to economic costs." *Affidavit of Richard L. Schmalensee*, note 6, *supra*, at page 24. The argument rests on a false premise: as demonstrated *supra*, at Section III.A and *infra*, at Section VI.A, the long distance market is already competitive and prices already approximate economic costs. Therefore, there is no countervailing benefit to an ILEC's anticompetitive price squeeze.

2. Increased likelihood of anticompetitive strategies designed to raise rivals' costs, more generally

105. A BOC will also be able to exercise market power by bundling services and making it more difficult for customers who subscribe to more than one service to switch carriers. Such bundling schemes will be much more effective for a firm with near monopoly market power in one portion of the bundle, here in the provision of local service. If a firm has significant market power, its competitors will have, even in the absence of bundling by the dominant firm, a difficult time attracting customers. A BOC's position as the entrenched monopoly provider will make it difficult for other firms to convince customers to switch carriers. If the BOC sells to customers bundles of local and toll services, the willingness of customers to switch will be that much less and the BOC's operation, as a whole, will be able effectively to lock in a significant portion of its customer base.

106. We stressed earlier the importance of both price and nonprice anticompetitive strategies available to the BOC. Forward integration by the BOC into long distance services would increase the span of potential markets, services and products which could provide a basis for anticompetitive strategies. This integration would expand the range of opportunities to engage in those strategies, would make it more difficult to detect or deter such behavior, and would increase incentives and opportunities to fund such behavior. For example, entry into unregulated long distance services would increase incentives to cross-subsidize and to

engage in other anticompetitive strategies to evade continuing local service regulations.[94]

3. Increased likelihood of anticompetitive behavior based on cross-subsidization of interLATA markets

107. The BOC can easily cross-subsidize its long distance operation (or its long distance affiliate) by not requiring its long distance affiliate to pay the full cost of the inputs it uses. For example, the long distance operation of the BOC will use the brand name of the BOC, one of its most important assets, without payment -- clearly cross-subsidization. Further, it is not clear how the costs will be divided in the joint marketing of the long distance and the local operations, raising the possibility of additional opportunities for cross-subsidization.

4. Decreased likelihood that the BOC will cooperate with local exchange entrants, as required by the Act

108. Entry by a BOC into interLATA services results in a fundamental change in the BOC's incentives to discriminate among long distance carriers. When the BOC is

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[94] Indeed, BellSouth's economic witness Glenn A. Woroch acknowledges that "[t]here are several potential anticompetitive practices which an integrated ILEC such as BellSouth might theoretically take." *Affidavit of Glenn A. Woroch on Behalf of BellSouth*, in the Matter of Application of BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision on In-region, InterLATA Services in Louisiana, Before the Federal Communications Commission, page 23 (November 1997); see also id., at page 8 ("Strategic behavior by an ILEC would become a concern . . . were its control of bottleneck network services is used to discourage entry into downstream markets, especially retail local exchange and long distance.")

restricted to offering local services, the BOC has no incentive to favor one long distance carrier over another. Because local access and long distance are complements (*i.e.*, a local loop is required to complete a long distance call), the BOC has an incentive to encourage as much long distance competition as possible. Competition in long distance drives down toll charges, stimulating demand for long distance services. In turn, BOC revenues increase both because of increases in access revenue -- which significantly exceeds the incremental cost associated with the traffic -- and because consumers who pay less for long distance service are likely to be willing to spend more on local services.

109. Once a BOC is also a long distance carrier, it has a strong incentive to discriminate in favor of its own long distance business. Before entry, local and long distance are complements; after entry, the BOC and other long distance carriers are competitors, and thus the BOC will lack the necessary incentive to provide services to the interexchange carriers, which the latter require in order to compete with the BOC both as a competing local exchange carrier and as a long distance carrier.

5. Increased costs of regulatory oversight to protect consumers and the competitive process and delaying the development of local competition

110. The most important social cost of premature BOC entry into interLATA services is likely to be the forestalling of the emergence of effective local competition. Implementing the pro-competitive policies of the Act is quite difficult and is likely to require

substantial regulatory oversight as long as the BOCs retain significant monopoly power over essential facilities. It is important to understand that the difficulties of introducing competition into local exchange markets are likely to be significantly greater than it was to introduce competition in long distance, which explains the need for more stringent regulatory requirements such as the unbundling and total service resale provisions of Section 251.[95]

111. Introducing local service competition is more difficult for at least five reasons. First, the capital investment per customer is much larger for local services than for long distance. In 1995, the investment-per-subscriber line was $1,828 for local services compared to $255 for that for AT&T -- a more than sevenfold difference.[96] This means that the BOC is likely to retain its role as the monopoly provider of facilities in many local markets for a number of years.

112. Second, entry into local services requires competitors to cooperate much more

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[95] Professor Schwartz argues that:

> "In the present context authorizing BOC entry prematurely and relying solely on post-entry safeguards to attempt to open BOC local markets to competition is especially dangerous . . .. The FCC's experience with trying to pursue Open Network Architecture in the face of incumbent LECs' resistance illustrates the difficulties involved."

See *Supplemental Affidavit of Marius Schwartz on Behalf of the U.S. Department of Justice,* note 74, *supra,* page 17.

[96] See *Statistics of Communications Common Carriers 1995/1996*, Federal Communications Commission, November 27, 1996. Local exchange plant in service was $278.946 billion (Table 2.7) and there were 152.601 million subscriber lines (Table 2.3); AT&T's total plant in service was $25.894 billion (AT&T financial data maintained in conformance with regulatory requirements) and there were 101.357 million subscriber lines (Table 8.12).

extensively than was necessary in long distance markets. In local services, entrants will need to purchase essential UNEs, wholesale, and interconnection services from a competitor. During the early days of long distance competition, competitors needed to both interconnect with AT&T and lease wholesale transport facilities, but this dependence was never as great and did not last as long as the CLECs' dependence on the BOC. In the long distance context, the option to build long distance transport bypass facilities offered more effective discipline than the analogous option of local bypass in local exchange markets.

113. Third, the technology of local exchange competition means that providers have less flexibility in where they locate facilities than does a long distance carrier. To provide local loop service, a carrier needs loops that go to each house. To provide long distance service, a carrier can locate its point of presence much more flexibly; its only constraint is that it sits within the LATA. This is also true for the location of switches and long-haul transport facilities. This added flexibility in the interLATA arena lowers the costs of constructing facilities and increases opportunities for competition among facilities over a wider geographical range.

114. Fourth, with BellSouth precluded from interLATA services, and consequently interested in promoting increased competition, regulators and the BOC's interests regarding the promotion of long distance competition are aligned. This alignment of interests eased the burden on regulators immediately following divestiture when effective competition was emerging because BellSouth is likely to have much better information about underlying costs

and demand than is available to the typical regulatory agency. No alignment of interests exist with respect to local markets.

115. Fifth, the local services provided by the BOC are an essential input to a wider class of products and services than is long distance and so there are a greater array of monopoly leveraging opportunities, giving the BOC a greater incentive to preserve its local monopoly.

116. Elimination of one form of simple regulation (*i.e.*, the interLATA entry restriction) would create increased incentives and opportunities for anticompetitive strategies which would be harder both to detect and to deter. Therefore premature entry by a BOC into interLATA services would increase the overall regulatory burden on state commissions and the FCC, which already face a significant regulatory challenge promoting local service competition.

V. RESPONSE TO CLAIMS OF JERRY A. HAUSMAN

117. Professor Hausman makes two main points in his declaration.[97] First, BOC entry into long distance will reduce long distance prices significantly, yielding economic benefits to residential customers of $6-$7 billion dollars per year. Second, if BOCs are permitted to enter long distance markets, then incentives for local entry are enhanced as both BOCs and interexchange carriers will want to offer "one-stop shopping" to residential customers. We refute these claims below.

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[97]See *Affidavit of Professor Jerry A. Hausman on Behalf of BellSouth*, note 5, *supra.*